IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED RESPONSIVE TESTIMONY OF:

Richard A. Furniss
Towers Perrin

April 15, 2004

I. INTRODUCTION

Q. Please state your name and position.

A. My name is Richard A. Furniss. I am a principal at Towers Perrin, specializing in executive compensation

Q. Did you also give pre-filed direct testimony in this case?

A. I did.

II. SUMMARY OF TESTIMONY

Q. Please provide us with an overview of your responsive expert testimony.

A. We were asked to review and comment on the analysis of executive compensation issues done by the OIC Staff's consultant, Mr. Donald Nemerov of PricewaterhouseCoopers LLP ("PwC"), on the reports that Mr. Nemerov prepared regarding executive compensation issues and on the other reports and pre-filed testimony on such issues (such as those portions of the Cantilo and the Blackstone reports that discuss executive compensation issues).

III. DETAILED RESPONSIVE TESTIMONY

Q. Have you submitted expert reports that discuss Mr. Nemerov's reports?

A. As I indicated in my Pre-filed Direct Testimony, I have submitted what I identified there as the Towers Perrin Report and the Towers Perrin Supplemental Report, both of which I incorporate herein by reference These two reports are responsive to the reports that Mr. Nemerov has submitted.

Q. In his Pre-filed Direct Testimony, Mr. Nemerov identified three reports and a "Corrections and Clarification" document that he has prepared. Have you reviewed each of the reports and the "Corrections and Clarification" document? And have your responded to them?

A. I have. I reviewed each of them shortly after they were filed. The Towers Perrin Report and the Towers Perrin Supplemental Report both deal with the issues that Mr. Nemerov raised in his reports. I attended Mr. Nemerov's December and March depositions. I also testified at my two depositions -- one on December 3, 2003 and the other on March 9, 2004 -- about the problems I had with his positions and conclusions. And since my depositions were each taken after his depositions, I had an opportunity in those depositions to discuss the problems I had with his work. Finally, I've reviewed his latest written piece, the "Corrections and Clarifications," numbered Exhibit S-37 and dated March 2004.

Q. Are there areas where Mr. Nemerov and you agree?

A. Yes. First, I believe it is fair to say that he agrees with the first section of the Towers Perrin Report, entitled "Premera Compensation." In that section, I discussed Premera's compensation philosophy; the involvement and independence of Premera's Compensation Committee and Board in setting compensation for its executives; and its use of an independent compensation consultant to assist the Committee and the Board. When he was asked about these issues in his deposition, Mr. Nemerov had no real dispute about the correctness of my observations on these issues. These are important points of agreement. They demonstrate that the Premera Board recognizes that <u>it</u> -- and not management -- has the responsibility to determine what the level of management's compensation should be.

Second, as a result of the changes regarding compensation that Premera made through its Amended Form A, Mr. Nemerov acknowledged (in Exhibit S-29, his February 27, 2004 Addendum, at page 2) that "many of the executive compensation issues" that he had raised in his previous reports "have been addressed by Premera and now fall within the range of market standards."

Third, we both believe that, after conversion, the executive compensation programs should have appropriate annual and long term incentive programs and that there is a role for stock options in the long term incentive program. Such programs are in the mutual interests of the policyholders and the shareholders. The difference between us is primarily in regard the extent to which we believe that the Compensation Committee and the Board need to have the ability to tailor the compensation programs to reflect the needs of the company as they arise. Mr. Nemerov would seek to impose rigid rules that try to predict today what will be needed a year or two years from now. I argue that such rigid rules are a bad idea because the market place changes very quickly and what seems like a good requirement now may be either too restrictive in the future or too lenient. The problem, of course, is that, in either event, Premera may not be able to provide the appropriate pay levels for its executives, to the detriment of the company and ultimately the policyholders and the shareholders. Better, I say, for the Compensation Committee and the Board to have the flexibility to take into consideration the points made by Mr. Nemerov in making their independent judgment but not to be handcuffed by those points. And Mr. Nemerov acknowledged in his March deposition that other companies in Premera's peer group do not have restrictions such as those that he is proposing here.

Fourth, Mr. Nemerov and I agree that the Compensation Assurances that are found at Exhibit E-8 of the Amended Form A provide significant controls on Premera's post-conversion executive compensation. In my view, those constraints reflect a highly conservative approach and that it would be a mistake to expand those controls. They are now more restrictive than those of other Blue Cross organizations that have converted recently to public ownership and, if expanded, would constitute risky restrictions on the ability of the Board to exercise independent judgment.

Q. So have the new provisions in the Amended Form A regarding executive compensation – Exhibit E-8, the changes to Exhibit G-10 and the Equity Incentive Plan – resolved many of the issues raised by Mr. Nemerov in his October 2003 report (Exhibit S-27) and his November 2003 addendum (Exhibit S-28)?

A. They have. Mr. Nemerov recognized that himself in his February 27, 2004 Report Addendum (Exhibit S-29). He so indicated in his Overall Conclusions (page 2) and in the fact that Exhibit S-29 lists only 8 remaining unresolved issues from his October 2003 report (see pages 3 through 5 of Exhibit S-29) and only one remaining unresolved issue from his November 2003 report (see page 6 of Exhibit S-29). Mr. Nemerov's February 27. 2004 report then went on to list five new issues that had been raised between the time he was deposed (December 1-2, 2003) and February 27, 2004, and in regard to two of the five issues, he reported that his "concern is mitigated."

Q. Did you deal with those issues that Mr. Nemerov described in his February 27, 2004 report as either unresolved or as new?

A. I did. My March 5, 2004 Supplemental Towers Perrin Report deals with each of those issues. Rather than repeat that report in a question and answer format, I am attaching the Supplemental Towers Perrin Report hereto as **Exhibit A** and incorporating it by reference.

The Supplemental Towers Perrin Report stated that the limitations on the Equity Incentive Plan in the Amended Form A are very conservative and are more restrictive than those of other Blue Cross organizations that have converted recently to public ownership. The Supplemental Towers Perrin Report also commented on three statements in the February 27, 3004 Letter and Supplemental Report of Cantilo & Bennett L.L.P ("Cantilo").

Q. Does it appear, however, that, in Mr. Nemerov's "Corrections and Clarification to Exhibits S-27, S-28 and S-29," he is still making corrections to his old reports?

A. It does. Of course, I made some corrections in the Towers Perrin Report as part of my corrections sheet to my deposition, so I assume Mr. Nemerov also wants to make corrections to his report. But many of his corrections to his earlier reports are irrelevant now that the Amended Form A has been filed.

Q. What is your overview of the areas where you and Mr. Nemerov still disagree?

A. With all due respect, I believe that, in regard to many of the "concerns" that Mr. Nemerov continues to have, he has failed to see the forest for the trees. Let me give you some examples.

In his "Corrections and Clarifications" report, Exhibit S-37, Mr. Nemerov devotes several pages to officer turnover rates. For some reason, he chooses a three year period -- 2000 to 2002 -- rather than the longer period (1998 through 2003) for which Premera data is available and he comes to the conclusion that Premera's voluntary officer turnover rate for that shorter period was [redacted] as opposed to what he says is an industry average of 7.7%. Without getting into a detailed discussion of these percentages and the small number of relevant companies in the database he uses, suffice it to say that, when you are

Proprietary Material Redacted

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talking about a total officer population of38 or 39, the difference between [redacted] (about [redacted] officers per year) versus 7.7% (2.9 or 3.0 officers per year) is hardly significant. And when one of those officers in one of those years is your CEO, perhaps "who" is more pertinent than "how many." But the really important point is that, whether the turnover is below average or average or above average, it really has nothing to do with whether the Commissioner should approve or disapprove a conversion, because Premera is not asking the Commissioner to approve the conversion on the basis of officer turnover rates.

A second example is Mr. Nemerov's extensive discussion in his "Corrections and Clarifications" report (at pages 9, 10 and 13 of Exhibit S-37) about Premera's DB SERP (Defined Benefit Supplemental Executive Retirement Plan) and DC SERP (Defined Contribution Supplemental Executive Retirement Plan). But he is ignoring the "forest" because, as he acknowledges on page 3, the benefits that the executives would receive under the plans are "at market": the DB SERP and the DC SERP are at market level and generally similar to such plans for Premera's peers. Thus the conclusion in our March 5th report, at page 9: "As PwC does not state that current benefits are above market level, we see no reason to change the plan design or reduce the benefits." In effect, Mr. Nemerov proposes tinkering with the design of a plan that he already has concluded provides compensation at market levels. Moreover, Mr. Nemerov's proposals regarding how those plans should be handled in the future are better used as suggestions for the Compensation Committee and the Board to consider than as mandates as to what they must do, regardless of whether it is appropriate to do so under the actual circumstances that exist in 2005 or 2006.

A third example is found in his report S-27 where he makes a number of recommendations regarding the design of Premera's annual and long-term incentive plan. Most of these are related to increasing the focus on financial measures and share price growth (post conversion). This is a clear example of areas that are appropriately the responsibility of the Board and its Compensation Committee. What performance measures to encourage – and what to discourage – are virtually always approved at the Board level, and always subject to change as business, market, and company conditions change.

To the extent that there are real disagreements between Mr. Nemerov and myself, I believe they center on whether the Compensation Committee and the Board should have additional constraints put upon their exercise of judgment in regard to executive compensation. I conclude that they shouldn't because such limitations serve only to put Premera at a competitive disadvantage and are inferior to the Compensation Committee and the Board making decisions based on the actual facts at hand, in the exercise of their fiduciary duty, aided by an independent consultant and doing so under the public scrutiny that a publicly-traded company faces every day.

Q. Mr. Nemerov's reports claim that publicly-traded health insurance companies do not provide a separate incentive program in addition to stock options. What is your understanding regarding that issue?

A. The evidence is to the contrary. For example, the 2004 Proxy Statement of Aetna, Inc. states that its executives receive both stock options and an LTIP as part of their long term compensation.

Other health insurance companies that have long-term incentive plans in addition to options include: Amerigroup, Anthem, CIGNA, Oxford, United Health and WellChoice.

We continue to believe strongly that the Board must retain the ability to tailor the compensation program so that all constituents are served, including shareholders and policyholders, without excessive focus on one group. Options focus on the end result of shareholders' concerns, which may be appropriate for some companies for some years. Cash and stock-based plans can incorporate specific measures that relate both to shareholders and other constituencies, and this may be appropriate as well.

IV. CONCLUSION

Q. After reviewing Mr. Nemerov's testimony and all of his reports and the statements regarding executive compensation in the Cantilo and Blackstone reports, what are the general conclusions you have about Premera's current executive compensation programs and practices?

A. I continue to conclude that the current executive compensation programs are reasonable and appropriate. There is nothing in Mr. Nemerov's testimony or reports that takes issue with my conclusion that Premera's Compensation Committee and Board have done a good job of making independent judgments about compensation needs. Nor does he disagree with my conclusion that Premera's use of a nationally recognized compensation consultant -- Mercer Consulting -- is consistent with best practices and assures that Premera's Compensation Committee has appropriate information about the range of compensation in peer group companies. We conducted an extensive and detailed analysis of Premera's actual executive compensation, and believe that it is competitive in the aggregate with an appropriate peer group of public and non-public peer companies, and that each of the top executives has a compensation package that is consistent with their individual responsibilities. Finally, we and Mr. Nemerov agree that the proposed executive compensation following conversion is at or below market practice.

Nor is there anything in the Cantilo or Blackstone reports that would cause me to change my conclusions.

Q. What impact, if any, does Mr. Nemerov's testimony and reports and the Cantilo and the Blackstone discussions about executive compensation have on the general conclusions that you have reached about Premera's post-conversion compensation plan?

A. Neither Mr. Nemerov nor Mr. Cantilo nor the Blackstone authors provided any compelling arguments that would cause me to revise my conclusions about Premera's post-conversion compensation plan. I still have every reason to conclude that Premera's post-conversion compensation for its executives will be reasonable and appropriate. It will continue to have an independent Compensation Committee and there will be the added assurance that the Foundations' nominee to the Premera Board will serve on the Compensation Committee for the first three years. The Compensation Assurances also require that Premera use an appropriate peer group regarding compensation. Also, as a public company, compensation paid to the top five executives, the design of the incentive program, and the reasoning of the Compensation Committee's award to the CEO will be publicly disclosed as part of Premera's SEC filings. Further, there are significant restrictions on the use of stock options that will ensure that any stock option grants are at reasonable and competitive levels. If the executives obtain any payment under those options, it will be because they have earned the payment by adding value for the shareholders.

Finally, the February 27, 2004 report of the Blackstone Group, Exhibit S-4, "Update Report on Valuation and Fairness of the Proposed Conversion," and the deposition testimony of the two Blackstone representatives -- Mr. Koplovitz and Mr. Alderson-Smith -- in March 2004 support my conclusion that Premera's equity incentive plan is reasonable and appropriate.

. . . .

Q. Does this conclude your pre-filed responsive testimony?

A. It does.

VERIFICATION

I, RICHARD A. FURNISS, declare under penalty of perjury of the laws of the State of Washington that the foregoing answers are true and correct.

Executed this ____ day of April, 2004, at New York City, New York.

/s/
RICHARD A. FURNISS

EXHIBIT A

Richard Furniss

EXHIBIT A

IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

REPORT OF

Towers Perrin

SUPPLEMENT TO

Review of Premera's Executive Compensation Program

March 5, 2004

CONFIDENTIAL and PROPRIETARY
NOT FOR PUBLIC DISCLOSURE

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INTRODUCTION

At the request of PREMERA, Towers Perrin has reviewed the amendments to the Company's Form A, including Exhibits G-10 and E-8 filed on February 5, 2004, and the Report Addendum prepared by PriceWaterhouseCoopers, dated February 27, 2004, and entitled "PREMERA's Executive Compensation Review Summary of Issues – Resolved or Pending". We also have comments on the Supplemental Reports and Letter from another OIC Consultant, Cantilo & Bennett.

Towers Perrin's findings and conclusions in our Review of PREMERA's Executive Compensation Program of November 2003 have not been changed materially by the PREMERA amendments.

Our overall observation is that the constraints on executive compensation to which PREMERA has agreed are highly conservative, and will considerably limit the ability of the Company and its directors to administer a competitive executive compensation program. We also observe that with one possible exception, the recommendations made by PriceWaterhouseCoopers in their Report Addendum would not be in the best interests of the Company from the viewpoints of policyholders, healthcare providers, future shareholders, and other constituents.

A. PwC REPORT ADDENDUM: FEBRUARY 27, 2004

The following section of our report is organized so as to address each of PwC's recommendations individually. We have not addressed those issues where PwC raises no concerns.

Issue # I-1: Long-Term Incentive Payout Determination (Page 3)

PwC Recommendation: "Long-term incentive payouts should be based on salary levels in effect at the time of the award/grant and NOT at the time of payout." The major rationale cited is compliance with IRC Section 162(m), not a reduction of PREMERA's target compensation.

Towers Perrin Observations: As a non-public company, PREMERA is not now subject to IRC Section 162(m) of the Internal Revenue Code. However, PwC's concern regarding compliance with Section 162(m) can be readily addressed by specifying a maximum dollar amount at the outset. We observe that using starting salary to define the LTIP payout is simpler from an administrative point-of-view.

We also note that if starting salary is used rather than ending salary, and assuming annual salary increases, awards will most likely be lower unless percent-of-salary targets are increased. We found in November that PREMERA's total compensation was competitive with market levels, and PwC raises no concerns regarding planned levels post Conversion; therefore there is no reason to reduce long-term incentives.

Towers Perrin Recommendation: We recommend either that maximum dollar awards be specified to comply with IRC Section 162(m) when applicable, or that beginning salary be used, along with a corresponding increase in target awards as a percent of salary, in order to maintain competitive compensation levels.

Issue # I-2: Voluntary Turnover (Page 4)

PwC Status: "Board belief not substantiated by data."

Towers Perrin Observations: Based on survey data from Watson Wyatt's 2003/2004 Insurance Industry Compensation Planning Report, total turnover (voluntary and involuntary) rates in the health/annuity/and life insurance industry for exempt personnel (e.g., management) are 10%, and for non-exempt staff 11%. We understand that PREMERA's officer turnover rates have been 14.93% for 2000-2002, and 16.67% for 2001-2003, considerably greater than market levels. We also note that because public companies generally include a greater number of executives in a long-term incentive plan than do non-public companies, and because long-term incentive plans generally provide for forfeiture of awards in the event of voluntary termination, the Board of Directors (the "Board") would have access to an additional tool to promote retention of the Company's officers following a public offering. In any event, we understand that retention was not a factor in the decision to pursue the Conversion.

Issue # I-3: Incentive Funding/Goal Setting – Annual Plan (Page 4)

PwC Recommendation: "...establish minimum performance goals that take into account prior years' performance results and management's expectations of next year's performance." This is based on PwC's belief that the minimum performance goals are "understated" vs. actual and historical results and budget.

Towers Perrin Observations: PwC continues to misstate or misinterpret the PREMERA Annual Incentive Plan. PREMERA's plan is very conservative in design; it establishes an operating income target and a minimum and maximum around that target. Actual operating income is compared to the range and if actual income is below the minimum, no award of any kind is granted. This result differs from the most commonly used approach to annual incentive plan design, which is to treat various measures independently, and allow a payout in one measure even if performance is below threshold for others.

If actual operating income exceeds the minimum, awards can then be adjusted (downward only) according to performance in areas such as membership, sales and marketing, IT, underwriting, etc. In other words, an initial award is determined according to actual operating profit compared to target, which could be greater or less than the target award. Performance in other areas is then assessed and can adjust the initial award downward if objectives are not met, but cannot increase it.

Because of the plan design, it is entirely appropriate to provide a wider-than-usual range around the profit target in order to increase the probability for *some* payout for performance other than operating income.

Towers Perrin Recommendation: We strongly recommend that no changes be made to the minimum operating income goal setting process.

Issue # I-3: Incentive Funding/Goal Setting – LTIP (Page 4)

PwC Recommendation: "...establish a minimum shareholder return before any payment is triggered."

Towers Perrin Observations: PwC is not clear regarding its definition of shareholder return, which could be financial (e.g., return on equity) or stock-based (e.g., share price increase plus dividends). If the former, we note that the Long-Term Incentive Plan already has a provision for a minimum return to shareholders (expressed as operating income) below which no award is paid out.

If the PwC recommendation refers to share price and dividends, we point out that the option portion (majority proportion) of the post-Conversion plan is structured automatically to have a value only when the shareholders realize a gain.

We also note that the performance measures in the LTIP include several that are not directly related to shareholder return, but are highly relevant to constituents, such as how well the Company serves its members. Further, PREMERA's LTIP, like that of most companies that use such plans in addition to options, contains measures that should lead to share price growth (e.g., membership, service, retention), and which the Company wants to specifically encourage.

Finally, Institutional Shareholder Services (ISS), a leading proxy voting advisory organization, has announced that it will not consider stock-based shareholder return in its consideration of proposals relating to compensation plans in the first three years of public ownership.

Towers Perrin Recommendation: We do not believe that the addition of a "shareholder return" minimum to the LTIP would be in the best interests of PREMERA's constituents, and strongly recommend against it.

Issue # I-4: Performance Measures (Page 4)

PwC Recommendations: "...de-emphasize the impact of non-financial performance measures for SVPs, EVPs and the CEO. A meaningful portion of the annual long-term incentive payout should be linked to the achievement of operating margin goals."

Towers Perrin Observations: Annual incentive plans are usually based on performance measures that management and the board believe best reflect the tasks that should be accomplished in the current year. While these measures are often financial, they may also include other measures that reflect the tasks needed to position the company for the future. Non-financial measures are, we believe, particularly relevant in the health insurance industry, as they represent the primary means to achieve adequate profitability, and include customer satisfaction, membership, retention and growth, service and quality. In our experience in the health insurance industry we observe that about **50%** of the annual incentive plan award for senior officers is determined by non-financial measures, contrary to the PwC assertion.

It should also be noted again that PREMERA's annual incentive plan is structured in a fashion that actually puts more emphasis on financial results than is apparent at first, as explained previously (observations, Issue I-3).

We also note that operating margin is not a common, or particularly informative, performance measure in the health insurance industry. Operating margin is not within the top-10 financial performance measures used for incentive plan purposes according to the Watson Wyatt survey cited above, or the measures identified by Towers Perrin in two surveys of the insurance industry. One major problem with this measure is the changing business mix in the health insurance industry, and the different margin characteristics of various sources of revenue. Each may have a respective margin, and using a single measure might encourage exiting low margin but value-creating businesses.

In most plan designs, achievement of non-financial objectives can be rewarded regardless of achievement of financial objectives. Therefore, PREMERA's plan is conservative compared to market practice.

Towers Perrin Recommendation: Towers Perrin recommends that PREMERA not change its process for establishing performance measures of the annual incentive plan.

Issue # I-5: Deferred Compensation (Page 5)

PwC Recommendation: "...PREMERA [should] implement Mercer's recommendation effective for 2004" to eliminate the match.

Towers Perrin Observation: Under this program, executives are required to defer a portion of their incentive compensation. The Company provides a partial match for the mandatory deferral. This is a multi-year program, and the amount of the match paid out is dependent on continued employment. We determined that compensation delivered by this plan did not lead to total compensation above market. Further, a number of executives already have deferred balances under this program which must still be paid out over several future years, and the Company has committed to match mandatory deferrals applicable for periods prior to the Conversion.

Towers Perrin Recommendation: PREMERA must honor its commitments to match deferrals made prior to the Conversion. We recommend that PREMERA eliminate the mandatory deferral program and corresponding matches on a prospective basis after Conversion.

Issue # I-6: Defined Contribution and Defined Benefit SERP (Page 5)

PwC Recommendation: "Include a provision....such that the aggregate retirement benefit...is offset by qualified retirement benefits," et al.

Towers Perrin Observations: PREMERA's DB SERP does include an offset for the qualified pension plan benefit. To the extent that the DC SERP does not provide an offset for qualified benefits, et al., then the recommended change would reduce overall benefits. As PwC does not state that current benefits are above market levels, we see no reason to change the plan design or to reduce the benefits.

Towers Perrin Recommendation: We recommend that no changes in plan design be made in connection with the proposed Conversion, but that the Compensation Committee of the Board continues to monitor and maintain benefit levels at competitive levels.

Issue # I-7: Change-in-Control ("CIC") – Walk-Away Rights (Page 5)

PwC Recommendation: "limit 'walk-away rights' to the CEO only."

Towers Perrin Observations: In order to put this issue in context, several preliminary points should be made. First, Conversion will not trigger the CIC program. Second, we observe that the commonly used "Constructive Termination" definition in the PREMERA CIC contract provides *full* CIC benefits in the event of a material reduction in the employees' duties and responsibilities, which is highly probable for senior executives in a CIC. Therefore, an executive is more likely to leave under this provision than the "walk-away" clause. We also note that providing only 50% of the original CIC benefits is extremely conservative and unusual. Further, the executive must remain for one year following a CIC to trigger this benefit, which should not only facilitate a smooth transition to a new owner, but also provide the new owner ample opportunity to create an appealing work environment to retain executives, and reduce the likelihood that this clause will come into use.

Finally, we note that CIC protection is provided under individual contracts which would have to be renegotiated.

Towers Perrin Recommendation: We recommend that the individual contracts with each executive not be renegotiated and changed as PwC proposes.

Issue # I-8: Change-in-Control – Enhanced DB SERP (Page 5)

PwC Recommendation: "Exclude severance benefits from Final Compensation in determining the enhanced DB SERP benefit."

Towers Perrin Observations: In a CIC, the PREMERA DB SERP recognizes the severance payments on an annualized basis, and does **not** include the entire benefit in the final year to calculate SERP benefits. In effect, the SERP simply bases retirement benefits on the salary and the *target* bonus in effect during the year in which the CIC occurs, and assumes up to three years at that rate of pay. This could mean, in fact, that the SERP is based on a *lesser* amount than actual annualized pay in the CIC year if actual bonus exceeds target bonus. The following excerpt from a PREMERA agreement details the plan:

Benefits Under the DB SERP

DB SERP. The Employee's Compensation, as defined under and for purposes of calculating benefits under the DB SERP, shall include the severance benefit payable in accordance with Section 3.1(a), calculated as if paid in monthly installments over the course of the Benefits Continuation Period. The Employer, in determining Final Compensation (as defined in the DB SERP), shall calculate average Compensation over the Employee's Benefits Continuation Period first, considering Compensation for the months preceding termination only as required to constitute a total of 36 months of Compensation. Actual Service, as defined in and for purposes of calculating benefits under the DB SERP, shall include the Benefits Continuation Period. Payments under this Section 3.1(c)(i) shall be paid at the time provided for payment of benefits under the DB SERP.

Some companies use actual bonus or maximum bonus rather than target, while others use pay in effect on the date of CIC and assume it *increases* for the next 3 years. Compared to these, PREMERA's plan is conservative.

Towers Perrin Recommendation: We recommend that the individual contracts with each executive not be renegotiated and changed as PwC proposes.

Issue # II-1: Long-Term Incentive Plan Continuation (Page 6)

PwC Recommendations: "...establish a minimum shareholder return before any LTIP incentive payment is triggered."

Towers Perrin Observations: We believe that it is not wise to establish additional shareholder return requirements for reasons previously stated. PwC apparently bases this recommendation on their observation that cash or stock-based incentive plans are "not prevalent" in PREMERA's public company peer group, especially in IPO situations. PREMERA is in a different situation because it is subject to more severe restrictions on option grants than are its peer companies, and share utilization of the peer companies is substantially higher as a percent of total shares. In fact, PREMERA must continue the LTIP in order to provide competitive total compensation because of these restrictions.

Further, we observe a trend in recent years to reduce the percentage of compensation delivered through options. This trend may not be observable in currently available proxy statements, as most show 2002 awards. However, 2003 custom surveys reflect the trend and show that 47% of general industry companies grant options along with another plan and 82% of major life insurance companies grant options along with cash or stock plans. The median value of options vs. total long-term awards for a representative senior executive is 57% for insurance companies with 2 or more plans.

Finally, the Company intends to use restricted stock as payment for the LTIP, which would enhance the emphasis on shareholder return.

Towers Perrin Recommendation: We recommend that no change be made to the LTIP.

Issue # III-1: Long-Term Incentive Plan Mix (Page 8)

PwC Recommendations: "...Establish a minimum shareholder return before any incentive payment is triggered. This ensures an appropriate pay and performance relationship exists, on behalf of the shareholders and the OIC."

Towers Perrin Observations: As mentioned in our response to Issue II-1, a trend of recent origin has been to reduce the percentage of compensation delivered through options. 2003 custom surveys reflect the trend and show that 47% of general industry companies use another plan along with options and 87% of major life insurance companies use other plans with options. Options represented 57% of total awards for companies with 2 or more plans.

Also mentioned previously, PREMERA's LTIP contains measures that are highly relevant not only to shareholders (e.g., operating income) as they represent financial measures that may have an impact on share price, but also to other PREMERA constituents (e.g., service).

The latest peer group information is from 2003 proxies reflecting long-term incentive plan data generally of early 2002.

Towers Perrin Recommendation: We do not believe that the addition of a "shareholder return" minimum to the LTIP, or a lower proportion of LTIP versus stock options would be in the best interests of PREMERA's constituents, and we strongly recommend against it.

Issue # III-2: Long-Term Incentive Award Opportunities (Page 8)

PwC Recommendations: "...Limit salary increases to verifiable market rates of percentage increases to executive salaries."

Towers Perrin Observations: PwC raises concerns regarding long-term incentive compensation. Without explanation, PwC recommends limiting salary increase to mitigate these concerns. Towers Perrin observes that PwC ignores

PREMERA's historically low positioning vs. competitive levels regarding total compensation. To the extent that post-Conversion compensation may increase, such increases would be through performance-based, at-risk compensation. Any value delivered from options would occur only as a result of increases in stock value, which would similarly increase value for all shareholders including the Foundations.

Limiting salary increases would, we believe, create an unnecessary constraint on the board as it administers the overall program (level and mix among elements) to provide compensation appropriate to PREMERA and within the bounds of prudence, shareholder scrutiny, and plan design.

Towers Perrin Recommendation: We recommend that no *a priori* rule be imposed limiting salary increases which would in effect further limit the exercise of judgment by the Board over executive pay within the boundaries already constraining its discretion.

Issue # III-3: Officer Base Salary Increases (Page 9)

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This section of our report addresses certain aspects of the compensation program that PREMERA has agreed to in its amended Form A. We point out how this program is more restrictive than those of other Blue Cross organizations that have converted recently to public ownership, and also demonstrate that the exercise of judgment by PREMERA's Board should not be further restricted.

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Further restriction on the share allocations among the officers may well hamper succession planning efforts or retention grants to this group for the following reasons:

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- Similarly, companies need to be flexible to provide retention grants when key individuals (often the senior level management) are being recruited for leadership positions at competitors.

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The Cantilo & Bennett Letter and Supplemental Report raise several issues related to executive compensation, which we discuss below. They do not change our previous observations and conclusions. Cantilo & Bennett's statements and our comments are as follows:

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Towers Perrin Comment:

As PREMERA has shown, supported by market data from Towers Perrin, PREMERA's management turnover rate has been *higher* than market levels. Further, as we stated earlier, we understand that retention was not a factor in the decision to pursue the Conversion.

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Towers Perrin Comment:

As Towers Perrin has noted previously, several of the PwC recommendations appear to be at odds with Cantilo & Bennett's concerns. In reading Cantilo & Bennett's report, we do not see any evidence to conclude that the prospects of such additional compensation influenced the Conversion decision.

EXHIBIT A

Richard Furniss

EXHIBIT A

IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

REPORT OF

Towers Perrin

SUPPLEMENT TO

Review of Premera's Executive Compensation Program

March 5, 2004

CONFIDENTIAL and PROPRIETARY
NOT FOR PUBLIC DISCLOSURE

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INTRODUCTION

At the request of PREMERA, Towers Perrin has reviewed the amendments to the Company's Form A, including Exhibits G-10 and E-8 filed on February 5, 2004, and the Report Addendum prepared by PriceWaterhouseCoopers, dated February 27, 2004, and entitled "PREMERA's Executive Compensation Review Summary of Issues – Resolved or Pending". We also have comments on the Supplemental Reports and Letter from another OIC Consultant, Cantilo & Bennett.

Towers Perrin's findings and conclusions in our Review of PREMERA's Executive Compensation Program of November 2003 have not been changed materially by the PREMERA amendments.

Our overall observation is that the constraints on executive compensation to which PREMERA has agreed are highly conservative, and will considerably limit the ability of the Company and its directors to administer a competitive executive compensation program. We also observe that with one possible exception, the recommendations made by PriceWaterhouseCoopers in their Report Addendum would not be in the best interests of the Company from the viewpoints of policyholders, healthcare providers, future shareholders, and other constituents.

A. PwC REPORT ADDENDUM: FEBRUARY 27, 2004

The following section of our report is organized so as to address each of PwC's recommendations individually. We have not addressed those issues where PwC raises no concerns.

Issue # I-1: Long-Term Incentive Payout Determination (Page 3)

PwC Recommendation: "Long-term incentive payouts should be based on salary levels in effect at the time of the award/grant and NOT at the time of payout." The major rationale cited is compliance with IRC Section 162(m), not a reduction of PREMERA's target compensation.

Towers Perrin Observations: As a non-public company, PREMERA is not now subject to IRC Section 162(m) of the Internal Revenue Code. However, PwC's concern regarding compliance with Section 162(m) can be readily addressed by specifying a maximum dollar amount at the outset. We observe that using starting salary to define the LTIP payout is simpler from an administrative point-of-view.

We also note that if starting salary is used rather than ending salary, and assuming annual salary increases, awards will most likely be lower unless percent-of-salary targets are increased. We found in November that PREMERA's total compensation was competitive with market levels, and PwC raises no concerns regarding planned levels post Conversion; therefore there is no reason to reduce long-term incentives.

Towers Perrin Recommendation: We recommend either that maximum dollar awards be specified to comply with IRC Section 162(m) when applicable, or that beginning salary be used, along with a corresponding increase in target awards as a percent of salary, in order to maintain competitive compensation levels.

Issue # I-2: Voluntary Turnover (Page 4)

PwC Status: "Board belief not substantiated by data."

Towers Perrin Observations: Based on survey data from Watson Wyatt's 2003/2004 Insurance Industry Compensation Planning Report, total turnover (voluntary and involuntary) rates in the health/annuity/and life insurance industry for exempt personnel (e.g., management) are 10%, and for non-exempt staff 11%. We understand that PREMERA's officer turnover rates have been 14.93% for 2000-2002, and 16.67% for 2001-2003, considerably greater than market levels. We also note that because public companies generally include a greater number of executives in a long-term incentive plan than do non-public companies, and because long-term incentive plans generally provide for forfeiture of awards in the event of voluntary termination, the Board of Directors (the "Board") would have access to an additional tool to promote retention of the Company's officers following a public offering. In any event, we understand that retention was not a factor in the decision to pursue the Conversion.

Issue # I-3: Incentive Funding/Goal Setting – Annual Plan (Page 4)

PwC Recommendation: "...establish minimum performance goals that take into account prior years' performance results and management's expectations of next year's performance." This is based on PwC's belief that the minimum performance goals are "understated" vs. actual and historical results and budget.

Towers Perrin Observations: PwC continues to misstate or misinterpret the PREMERA Annual Incentive Plan. PREMERA's plan is very conservative in design; it establishes an operating income target and a minimum and maximum around that target. Actual operating income is compared to the range and if actual income is below the minimum, no award of any kind is granted. This result differs from the most commonly used approach to annual incentive plan design, which is to treat various measures independently, and allow a payout in one measure even if performance is below threshold for others.

If actual operating income exceeds the minimum, awards can then be adjusted (downward only) according to performance in areas such as membership, sales and marketing, IT, underwriting, etc. In other words, an initial award is determined according to actual operating profit compared to target, which could be greater or less than the target award. Performance in other areas is then assessed and can adjust the initial award downward if objectives are not met, but cannot increase it.

Because of the plan design, it is entirely appropriate to provide a wider-than-usual range around the profit target in order to increase the probability for *some* payout for performance other than operating income.

Towers Perrin Recommendation: We strongly recommend that no changes be made to the minimum operating income goal setting process.

Issue # I-3: Incentive Funding/Goal Setting – LTIP (Page 4)

PwC Recommendation: "...establish a minimum shareholder return before any payment is triggered."

Towers Perrin Observations: PwC is not clear regarding its definition of shareholder return, which could be financial (e.g., return on equity) or stock-based (e.g., share price increase plus dividends). If the former, we note that the Long-Term Incentive Plan already has a provision for a minimum return to shareholders (expressed as operating income) below which no award is paid out.

If the PwC recommendation refers to share price and dividends, we point out that the option portion (majority proportion) of the post-Conversion plan is structured automatically to have a value only when the shareholders realize a gain.

We also note that the performance measures in the LTIP include several that are not directly related to shareholder return, but are highly relevant to constituents, such as how well the Company serves its members. Further, PREMERA's LTIP, like that of most companies that use such plans in addition to options, contains measures that should lead to share price growth (e.g., membership, service, retention), and which the Company wants to specifically encourage.

Finally, Institutional Shareholder Services (ISS), a leading proxy voting advisory organization, has announced that it will not consider stock-based shareholder return in its consideration of proposals relating to compensation plans in the first three years of public ownership.

Towers Perrin Recommendation: We do not believe that the addition of a "shareholder return" minimum to the LTIP would be in the best interests of PREMERA's constituents, and strongly recommend against it.

Issue # I-4: Performance Measures (Page 4)

PwC Recommendations: "...de-emphasize the impact of non-financial performance measures for SVPs, EVPs and the CEO. A meaningful portion of the annual long-term incentive payout should be linked to the achievement of operating margin goals."

Towers Perrin Observations: Annual incentive plans are usually based on performance measures that management and the board believe best reflect the tasks that should be accomplished in the current year. While these measures are often financial, they may also include other measures that reflect the tasks needed to position the company for the future. Non-financial measures are, we believe, particularly relevant in the health insurance industry, as they represent the primary means to achieve adequate profitability, and include customer satisfaction, membership, retention and growth, service and quality. In our experience in the health insurance industry we observe that about **50%** of the annual incentive plan award for senior officers is determined by non-financial measures, contrary to the PwC assertion.

It should also be noted again that PREMERA's annual incentive plan is structured in a fashion that actually puts more emphasis on financial results than is apparent at first, as explained previously (observations, Issue I-3).

We also note that operating margin is not a common, or particularly informative, performance measure in the health insurance industry. Operating margin is not within the top-10 financial performance measures used for incentive plan purposes according to the Watson Wyatt survey cited above, or the measures identified by Towers Perrin in two surveys of the insurance industry. One major problem with this measure is the changing business mix in the health insurance industry, and the different margin characteristics of various sources of revenue. Each may have a respective margin, and using a single measure might encourage exiting low margin but value-creating businesses.

In most plan designs, achievement of non-financial objectives can be rewarded regardless of achievement of financial objectives. Therefore, PREMERA's plan is conservative compared to market practice.

Towers Perrin Recommendation: Towers Perrin recommends that PREMERA not change its process for establishing performance measures of the annual incentive plan.

Issue # I-5: Deferred Compensation (Page 5)

PwC Recommendation: "...PREMERA [should] implement Mercer's recommendation effective for 2004" to eliminate the match.

Towers Perrin Observation: Under this program, executives are required to defer a portion of their incentive compensation. The Company provides a partial match for the mandatory deferral. This is a multi-year program, and the amount of the match paid out is dependent on continued employment. We determined that compensation delivered by this plan did not lead to total compensation above market. Further, a number of executives already have deferred balances under this program which must still be paid out over several future years, and the Company has committed to match mandatory deferrals applicable for periods prior to the Conversion.

Towers Perrin Recommendation: PREMERA must honor its commitments to match deferrals made prior to the Conversion. We recommend that PREMERA eliminate the mandatory deferral program and corresponding matches on a prospective basis after Conversion.

Issue # I-6: Defined Contribution and Defined Benefit SERP (Page 5)

PwC Recommendation: "Include a provision....such that the aggregate retirement benefit...is offset by qualified retirement benefits," et al.

Towers Perrin Observations: PREMERA's DB SERP does include an offset for the qualified pension plan benefit. To the extent that the DC SERP does not provide an offset for qualified benefits, et al., then the recommended change would reduce overall benefits. As PwC does not state that current benefits are above market levels, we see no reason to change the plan design or to reduce the benefits.

Towers Perrin Recommendation: We recommend that no changes in plan design be made in connection with the proposed Conversion, but that the Compensation Committee of the Board continues to monitor and maintain benefit levels at competitive levels.

Issue # I-7: Change-in-Control ("CIC") – Walk-Away Rights (Page 5)

PwC Recommendation: "limit 'walk-away rights' to the CEO only."

Towers Perrin Observations: In order to put this issue in context, several preliminary points should be made. First, Conversion will not trigger the CIC program. Second, we observe that the commonly used "Constructive Termination" definition in the PREMERA CIC contract provides *full* CIC benefits in the event of a material reduction in the employees' duties and responsibilities, which is highly probable for senior executives in a CIC. Therefore, an executive is more likely to leave under this provision than the "walk-away" clause. We also note that providing only 50% of the original CIC benefits is extremely conservative and unusual. Further, the executive must remain for one year following a CIC to trigger this benefit, which should not only facilitate a smooth transition to a new owner, but also provide the new owner ample opportunity to create an appealing work environment to retain executives, and reduce the likelihood that this clause will come into use.

Finally, we note that CIC protection is provided under individual contracts which would have to be renegotiated.

Towers Perrin Recommendation: We recommend that the individual contracts with each executive not be renegotiated and changed as PwC proposes.

Issue # I-8: Change-in-Control – Enhanced DB SERP (Page 5)

PwC Recommendation: "Exclude severance benefits from Final Compensation in determining the enhanced DB SERP benefit."

Towers Perrin Observations: In a CIC, the PREMERA DB SERP recognizes the severance payments on an annualized basis, and does **not** include the entire benefit in the final year to calculate SERP benefits. In effect, the SERP simply bases retirement benefits on the salary and the *target* bonus in effect during the year in which the CIC occurs, and assumes up to three years at that rate of pay. This could mean, in fact, that the SERP is based on a *lesser* amount than actual annualized pay in the CIC year if actual bonus exceeds target bonus. The following excerpt from a PREMERA agreement details the plan:

Benefits Under the DB SERP

DB SERP. The Employee's Compensation, as defined under and for purposes of calculating benefits under the DB SERP, shall include the severance benefit payable in accordance with Section 3.1(a), calculated as if paid in monthly installments over the course of the Benefits Continuation Period. The Employer, in determining Final Compensation (as defined in the DB SERP), shall calculate average Compensation over the Employee's Benefits Continuation Period first, considering Compensation for the months preceding termination only as required to constitute a total of 36 months of Compensation. Actual Service, as defined in and for purposes of calculating benefits under the DB SERP, shall include the Benefits Continuation Period. Payments under this Section 3.1(c)(i) shall be paid at the time provided for payment of benefits under the DB SERP.

Some companies use actual bonus or maximum bonus rather than target, while others use pay in effect on the date of CIC and assume it *increases* for the next 3 years. Compared to these, PREMERA's plan is conservative.

Towers Perrin Recommendation: We recommend that the individual contracts with each executive not be renegotiated and changed as PwC proposes.

Issue # II-1: Long-Term Incentive Plan Continuation (Page 6)

PwC Recommendations: "...establish a minimum shareholder return before any LTIP incentive payment is triggered."

Towers Perrin Observations: We believe that it is not wise to establish additional shareholder return requirements for reasons previously stated. PwC apparently bases this recommendation on their observation that cash or stock-based incentive plans are "not prevalent" in PREMERA's public company peer group, especially in IPO situations. PREMERA is in a different situation because it is subject to more severe restrictions on option grants than are its peer companies, and share utilization of the peer companies is substantially higher as a percent of total shares. In fact, PREMERA must continue the LTIP in order to provide competitive total compensation because of these restrictions.

Further, we observe a trend in recent years to reduce the percentage of compensation delivered through options. This trend may not be observable in currently available proxy statements, as most show 2002 awards. However, 2003 custom surveys reflect the trend and show that 47% of general industry companies grant options along with another plan and 82% of major life insurance companies grant options along with cash or stock plans. The median value of options vs. total long-term awards for a representative senior executive is 57% for insurance companies with 2 or more plans.

Finally, the Company intends to use restricted stock as payment for the LTIP, which would enhance the emphasis on shareholder return.

Towers Perrin Recommendation: We recommend that no change be made to the LTIP.

Issue # III-1: Long-Term Incentive Plan Mix (Page 8)

PwC Recommendations: "...Establish a minimum shareholder return before any incentive payment is triggered. This ensures an appropriate pay and performance relationship exists, on behalf of the shareholders and the OIC."

Towers Perrin Observations: As mentioned in our response to Issue II-1, a trend of recent origin has been to reduce the percentage of compensation delivered through options. 2003 custom surveys reflect the trend and show that 47% of general industry companies use another plan along with options and 87% of major life insurance companies use other plans with options. Options represented 57% of total awards for companies with 2 or more plans.

Also mentioned previously, PREMERA's LTIP contains measures that are highly relevant not only to shareholders (e.g., operating income) as they represent financial measures that may have an impact on share price, but also to other PREMERA constituents (e.g., service).

The latest peer group information is from 2003 proxies reflecting long-term incentive plan data generally of early 2002.

Towers Perrin Recommendation: We do not believe that the addition of a "shareholder return" minimum to the LTIP, or a lower proportion of LTIP versus stock options would be in the best interests of PREMERA's constituents, and we strongly recommend against it.

Issue # III-2: Long-Term Incentive Award Opportunities (Page 8)

PwC Recommendations: "...Limit salary increases to verifiable market rates of percentage increases to executive salaries."

Towers Perrin Observations: PwC raises concerns regarding long-term incentive compensation. Without explanation, PwC recommends limiting salary increase to mitigate these concerns. Towers Perrin observes that PwC ignores

PREMERA's historically low positioning vs. competitive levels regarding total compensation. To the extent that post-Conversion compensation may increase, such increases would be through performance-based, at-risk compensation. Any value delivered from options would occur only as a result of increases in stock value, which would similarly increase value for all shareholders including the Foundations.

Limiting salary increases would, we believe, create an unnecessary constraint on the board as it administers the overall program (level and mix among elements) to provide compensation appropriate to PREMERA and within the bounds of prudence, shareholder scrutiny, and plan design.

Towers Perrin Recommendation: We recommend that no *a priori* rule be imposed limiting salary increases which would in effect further limit the exercise of judgment by the Board over executive pay within the boundaries already constraining its discretion.

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